Quarterly Portfolio Update

*Amundi Funds II – Real Assets Target Income**
30 March 2018

MULTI-ASSET
COMMENTARY

Market Review

Markets remained disoriented for most of the quarter amidst hawkish central bank rhetoric given stronger payroll reports in the U.S., higher inflationary prospects, potential trade wars between the U.S. and China, and an ongoing reshuffling in the Trump administration. Worries in the U.S. Technology sector and a slowdown in some lead indicators in Europe spooked investors further, thus deepening the sell-off.

Equity markets bore the brunt of the decline in investor sentiment; MSCI[1] World fell -1.7% led by losses in Europe (Eurostoxx -4.1%) and Japan (Nikkei -5.8%), which faced headwinds from appreciating currencies particularly versus the U.S. Dollar. Meanwhile, the U.S. fared better, driven also by resilient domestic macro and corporate earnings data (S&P -1.2%). MSCI Emerging Markets (EM) outperformed adding +1.1% in U.S. Dollars but with a marked divergence in performance across countries. Russia's Micex, for instance, gained +8.3% supported by higher oil prices while China's domestic market Shanghai Composite fell -4.2% due to U.S. trade tariffs.

Within fixed income, hawkish signals from central banks put upward pressure on global government bond yields in the first half of Q1. However, yields compressed in the latter half, as investors rushed into safe haven assets. In the U.S., 10-year yields tested the 3% levels in mid-February, but ended the quarter at 2.74% (+33bps in Q1). In the eurozone, Germany followed a similar pattern but 10-year yields rose by only +7bps to end the quarter at 0.49% as investors pared back expectations of a rate hike from the ECB this year. The periphery experienced a notable yield compression on the back of an improved political outlook; 10-year yields in Italy and Spain fell -22bps and -40bps respectively.

Higher underlying bond yields in the U.S. weighed on higher beta corporate bond sectors; High Yield (HY) was adversely impacted. Bloomberg Barclays Global HY index lost -0.4% with larger losses registered in the U.S. due to rate hike expectations. Meanwhile, Investment Grade (IG) in the eurozone particularly, benefitted from lower sovereign bond yields and continued investor appetite for Euro issues, which helped the Bloomberg Barclays Global IG index post a gain of +1.4%.

In currency markets, the U.S. Dollar fell versus the Euro (-2.6%), Sterling (-3.6%), Yen (-5.7%) and several EM currencies, despite the hawkish rate outlook from Fed officials. The Yen benefited from the risk-off environment while Sterling was supported by positive Brexit-related developments. Commodity related currencies, such as Australian Dollar and New Zealand Dollar, were losers on the other hand given weakness in industrial metals.
Commodity markets were overall positive return generators in Q1 due to oil. West Texas Intermediate rebounded strongly in March and ended Q1 up +7.5%. The main catalyst was the appointment of John Bolton as new U.S. national security advisor, who is a prominent opponent of Iran and Venezuela (thus negative for the Iran nuclear deal). Industrial metals such as aluminium and steel meanwhile fell sharply in February and March, amidst protectionism measures, thus ending the quarter down -7.2%. Gold (+1.7%) benefited from weaker investor sentiment while Silver (-3.4%) lost due to concerns of trade tariffs extending to other metals.

Portfolio Review

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The Portfolio lost value in Q1 amidst a volatile market backdrop. Losses were driven by the directional exposure to equity sectors within the Macro Strategy although Selection and Satellite Strategies helped to offset some losses. Macro Hedging trades were flat.

We suffered the most in Real Estate, Energy and Transportation sectors although the reduced allocation to these sectors helped. Selection in U.S. and Canadian Real Estate was hit in an environment of rising bond yields while REITs positioning in Japan and Europe benefited from domestic yield compression. Option writing in the sector also contributed positively; call options used to reduce exposure to UK Land Securities was the best performer. Within Transportation, losses were led by

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power and automation technologies provider ABB Ltd. and construction and industrial services provider Bilfinger.

A negative bias to Energy Infrastructure and Materials helped, as did the exposure to inflation linked bonds. Within Energy Infrastructure, gains from oil field services company TechnipFMC plc were offset by option writing, where calls and puts sold on Golar LNG were unsuccessful. Within Materials, Gold mining stocks (Newmont, Goldcorp) benefited from rising gold prices. Options written on single names also helped.

Within Satellites Strategies, Fish Farming, Photonics and Forest, Paper and Packaging were the best performing thematic strategies while Lithium and Global Aging generated losses. Within commodities, we benefited from exposure to Corn while Wheat and Coffee detracted.

With regards to income, a majority of the income generated came from dividends and option writing with a smaller contribution from bond coupons.

Asset Allocation (Macro Strategy)

As a reminder of our Portfolio strategy, we bias companies in sectors whose incomes are sensitive to global inflationary trends given their link to the underlying economy (eg: Real Estate, Energy and Infrastructure, etc.). We use option overlays (i.e. writing calls and puts) to not only generate income but also to manage sector exposure and overall Portfolio volatility. We often sell stocks and sell out-of-the-money put options on the stock instead, thus aiming to buy the stock at a more favourable price should the option get exercised. This should help reduce the overall directionality of the Portfolio in our view.

Our investment outlook for Q2 remains positive but we have increased the defensive positioning of the portfolio given the backdrop of rising risks. We expect the normalisation of Central Bank (CB) monetary policies to remain gradual as we transition towards a late financial cycle. Although fundamentals remain sound due to the ongoing synchronised global growth recovery, equity markets have suffered the most since February. After the release of disappointing economic surprise indices in the eurozone and Japan, investors appear to be concerned of a slow-down in economic momentum. This could hurt corporate profitability prospects going forward. The potential implementation of protectionist trade measures could further dampen the earnings outlook.

Our fixed income allocation remains limited and slightly lower than the past quarter. We have gradually reduced duration and spread duration through DM sovereign and corporate bond sectors.

Within commodities, we hold exposure to Gold through gold miners' stocks and our gold mining fund. We also hold Silver; we are constructive given falling stockpiles and a pick-up in growth prospects (given the use for industrial purposes). To diversify risk, we hold exposure to Corn and Wheat which we prefer over Soybeans for instance as we view this as susceptible to trade war uncertainty We are also positive on Natural Gas given drawdowns in inventories and strong industrial demand.

We have implemented some growth-oriented equity strategies during the quarter including a long Topix banks futures. Japanese Banks are interesting in our view due to their low valuations, high quality and potential for high dividend yield.

On currencies, we hold a reduced exposure to the U.S. Dollar, as the currency may face headwinds from an increasing current account deficit (resulting from the fiscal stimulus) and protectionism fears.

Macro Hedging

We benefited from holding hedges on European and U.S. equity exposure in Q1. We have closed the hedge in Europe (via a put option on the Eurostoxx) and our primary hedge now is the long put option on the S&P.

Selection & Satellite Strategy

Within equities, our largest positioning is to Real Estate. However, we have reduced exposure to bond proxy sectors such as Real Estate and Infrastructure as they may suffer amidst rising bond yields. Within Real Estate, we prefer selective holdings in Europe and U.S. primarily as well as some exposure to Asia through a diversified ETF. We bias companies with office space in Continental Europe as well as residential and senior homes.

In order to reduce Portfolio beta amidst heightened volatility, we have increased exposure to defensive sectors such as Consumer Staples using put options on select names. We have also reduced exposure in Energy also by selling call options, for instance on BP. We have also become more selective in Energy Infrastructure by reducing the ETF on the Alerian MLP Index (diversified exposure to mid-stream Energy companies in the U.S.) and investing in single names. We are also using options to manage exposure within the sector.

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We have maintained the thematic equity positioning in the Portfolio through low-correlated Satellite Strategies including Fish Farming, Forest Paper & Packaging, Global Aging & Healthcare, Lithium Mining and Global Water, while closing our exposure to Fibre optics companies such as Applied Optoelectronics and Acacia

HY exposure remains limited in the environment of rising credit and liquidity risk. We also hold a select exposure to EM bonds, mostly sovereign bonds in hard currency. We are biased to inflation linked bonds across Europe and U.S. We expect these bonds to benefit from a gradual pick-up in inflation due to normalising CB policies (more so in the U.S.) and tighter labour markets (also in the U.S.).

Outlook

Although we have trimmed risks in the Portfolios, we maintain a positive view on risk assets given strong fundamentals at macro and corporate levels. Global growth remains resilient due to solid consumption and strengthening capex growth. On the other hand, macro indicators appear to be rolling over. Volatility also appears to be on the rise; investor fear gauges such as the VIX spiked in early February and remains elevated relative to previous quarters due to heightened uncertainty.

At the centre of market concerns are fears of protectionist trade policies between U.S. and China and potential contagion effects. We do not expect to see a full-blown trade war, despite some recent escalation with China. However, we acknowledge that this can be disruptive for investor confidence, especially against a backdrop of diminishing liquidity and anticipated tighter financial conditions. In the worst case scenario, it could even derail the normalisation path for CB if global growth suffers as a result of trade wars. We prefer to remain cautiously positioned as a result.

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